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In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 782

MADISON FUND, INC. (formerly The Pennroad Corporation), PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

This case involves the meaning of a prior decision rendered by the Third Circuit. The Third Circuit, sitting *en banc*, upheld the Commissioner's interpretation. In view of the limited question involved, no further review is warranted.

In 1947 petitioner received approximately $12,000,000 in settlement of three shareholders' derivative suits. In those suits the plaintiffs asserted that the Pennsylvania Railroad had controlled the petitioner and compelled it to invest in the stock of eight railroad companies at exhorbitant prices, and to conduct freight forwarding transactions through a subsidiary

for the benefit of Pennsylvania and to loss of its own shareholders.

The Commissioner asserted an income tax on a portion of the $12,000,000 recovered by petitioner in 1947 on two grounds. First, he alleged that part of the recovery represented a claim for lost profits from the freight forwarding venture which would have been ordinary income. Second, he allocated the balance of the recovery to four of the investments involved in the suits, reducing the basis of each asset and producing income in the case of one investment, the adjusted basis of which was less than the amount allocated to it.

The Tax Court rejected the Commissioner's attempt to tax any of the $12,000,000 in the year of receipt on the grounds that none of the recovery represented lost profits and that the Commissioner's method of allocation was arbitrary. *Pennroad* v. *Commissioner,* 21 T.C. 1087. In affirming, the Third Circuit stated (228 F. 2d 329, 332):

> We hold that, under the circumstances at bar, Pennroad was entitled to the restoration of its capital before the principle of allocation could become applicable. * * *

This present litigation arises from a dispute over the meaning of that sentence.

After 1947 petitioner sold the remaining investments involved in the three derivative suits. In computing its gain or loss on the sales petitioner made no adjustment to the basis of each asset to account for the partial restoration of capital represented by the $12,000,000 recovery.

The Commissioner rejected this procedure and asserted that some adjustment to basis was necessary. The Code clearly requires an adjustment of basis for a return of capital. 1954 Code §§ 1001, 1002, 1011, 1016. In a case like the present one where a lump sum is received as a partial return of the capital which a taxpayer has invested in an aggregate of assets, the amount recovered must be allocated among the assets on a pro rata basis in order to determine gain or loss in the year of sale. *Bancitaly Corp.* v. *Commissioner,* 34 B.T.A. 494; *Warren* v. *Commissioner,* 193 F. 2d 996 (C.A. 1); *Blum* v. *Commissioner,* 5 T.C. 702; *Santa Maria Gas Co.* v. *Commissioner,* 10 B.T.A. 1412.

Petitioner did not contest these general principles but asserted that in this case no allocation was necessary because the Third Circuit had held, as quoted above, that "Pennroad was entitled to the restoration of its capital before the principle of allocation could become applicable." Since it was admitted that Pennroad had realized a greater loss than it had recovered, petitioner contended that no allocation was necessary.

The Commissioner, on the other hand, took the position that petitioner was misconstruing the sentence it relied on. The Third Circuit in its original opinion did not decide whether the amount recovered should be allocated among the various investments for purposes of determining gain or loss in the year of sale. The Commissioner asserted that the prior opinion, and the sentence in question, merely addressed itself to the issue then before the court—whether the

$12,000,000 recovery could be allocated in the year of receipt to produce income in that year—and not to the issue of the basis of the assets at the time of a later sale. The dispute between the parties thus boiled down to what the Third Circuit meant in its prior decision.

In the instant case the Tax Court (43 T.C. 215) agreed with the Commissioner's interpretation of the Third Circuit's opinion because, it reasoned, accepting petitioner's contention "would do violence to the statutory scheme of reporting gains and losses on an annual basis." 43 T.C. at 231. Accordingly, it allocated the $12,000,000 among the assets on the basis of their relative fair market values—a method not challenged by the petitioner. On appeal the Third Circuit, sitting *en banc,* including one judge who sat on the original panel, rejected the petitioner's interpretation of its original opinion and agreed with the Commissioner. 365 F. 2d 471.

The Third Circuit's decision is clearly correct. It is in harmony with the general principle that where a lump sum has been received as a partial return of the capital which a taxpayer has invested in an aggregate of assets, the recovery must be allocated pro rata among the assets as a reduction of the taxpayer's basis in the assets. Furthermore, since the issue in this litigation is what the Third Circuit meant in its prior opinion, the Third Circuit sitting *en banc* is the court best qualified to answer that question.

Petitioner raises for the first time in its petition the argument that its reliance on its own misconstruction of the original opinion will produce an income tax liability it could have avoided. Assuming that is the case, there is certainly no principle of law that detrimental reliance on its own erroneous construction of a judicial opinion entitles a litigant to have that erroneous construction accepted.

The decision below is correct and involves no conflict of decisions or important question. The petition for a writ of certiorari should, therefore, be denied.

Respectfully submitted.

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